August has been without doubt an eventful month: the combination of trade and to some extent Fed policy has destabilised the markets. Tariff tensions are unlikely to go away, but may rise and fall substantially. Considering this, the lack of fundamental catalysts and another blow to business confidence which is undermining near-term capex, we are maintaining defensive positioning with relatively low exposure to equities.

The 25bps rate cut by the Fed at the end of July and the lack of future guidance during their press conference, which led the yield curve to flatten and the US dollar to appreciate\(^1\), fell short of market expectations. This followed an announcement\(^2\) by US President Trump of a 10% tariff on the remaining $300 billion worth of Chinese goods from 1 September, which created additional uncertainty on the global growth slow down, at a time when US corporates were already in the midst of an earnings slow-down. Market risk receded, when U.S. Trade Representative announced a delay to the 10% tariff on certain Chinese goods until 15 December\(^3\), but only temporarily before China announced retaliatory tariffs of 10% and 5% on $75 billion worth of Chinese goods, from 1 September and 15 December\(^4\).

Agriculture goods and autos imported from the US will be the focus of the latest increase. This triggered an immediate reaction from President Trump, who announced an increase from 25% to 30% for the $250bn of tariffed Chinese products on 1 October and from 10% to 15% on $300bn of goods due to come into effect on 1 September and 15 December 2019\(^5\).

\(^1\) Source: Bloomberg, 31 July 2019
\(^2\) Source: Bloomberg, 1 August 2019
\(^3\) Source: Bloomberg, 13 August 2019
\(^4\) Source: Bloomberg, 23 August 2019

Andrew is the Lead Portfolio Manager for the Global Balanced Risk Control Strategy (GBaR). He joined Morgan Stanley in 2008 and has over 30 years of industry experience.
Looking back at this sequence of events, August has been a month with no lack of surprises both on monetary and trade policies. However, what is different this time is that the latest round of threatened US tariffs on Chinese goods would hit consumers disproportionately, relative to previous tariff rounds. In the past, most tariffs were falling on intermediate goods, typically components of finished goods, where producers have been able to cushion consumers by absorbing some of the price increase.

**Breakdown of Chinese goods affected by latest $300bn US tariff threat**

A coordinated fiscal and monetary stimulus could still help counter the tariffs headwinds. On the fiscal front, if we look at the key regions, in China, a state-driven intervention will help to counter weak growth; in the US, an infrastructure stimulus is still on the table; and in Europe, populist governments are pushing for anti-austerity fiscal stance along with climate change-driven investment agenda. On the monetary side, a coordinated stimulus seems to prevail across different countries, with an increasing proportion of central banks cutting rates.

**Monetary stimulus: The proportion of countries cutting rates is rising**

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*5 Source: USITC, United Nations, Goldman Sachs Global Investment Research. Data as of 5 August 2019. Forecasts/estimates are based on current market conditions, subject to change, and may not necessarily happen.*

*6 Source: Bloomberg, Datastream, MSIM. Data as of 5 August 2019. Left hand chart: Rate forecasts are based on December Futures or where unavailable consensus interest rate expectations. Developed Market (DM) countries (11 in total) included in the calculation are sourced from MSCI World index constituents for which data is available. Emerging Market (EM) countries (17 in total) included in the calculation are sourced from JPM GBI EM index constituents for which data is available. Forecasts/estimates are based on current market conditions, subject to change, and may not necessarily happen.*
What we should not underestimate is that the latest tariffs escalations put the base level of investment at risk. Weak corporate earnings growth is likely to continue to suppress business investment in 2019. This, combined with declining business confidence, is undermining near-term capex intentions, which were already on a downward trend.

**Capex intentions and business conditions are on a downward trend**

![Graph showing capex intentions and business conditions on a downward trend](image)

Europe is certainly not immune to the global slowdown in activity. Following 6 months of contraction, industrial activity in Europe is still deteriorating. Soft domestic and external conditions are contributing to the malaise. In September 2018, European auto sales collapsed, but almost 12 months later sales have yet to normalise in both Europe and the rest of the world, potentially suggesting that the downturn is more structural than cyclical in nature. The risk of a hard Brexit is also re-emerging, which would exacerbate current macro and in particular Europe-specific headwinds. Regardless of the outcome, the persistent uncertainty is likely to prove to be a drag on businesses and investors alike.

**No export-driven recovery: Eurozone new export orders fell back to a cycle low in July**

![Graph showing Eurozone PMI Manufacturing New Export Orders](image)

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7 Source: Bloomberg, MSIM. Data as of 5 August 2019. US Empire Manufacturing Survey conducted on a monthly basis by the Federal Reserve Bank of New York, tracks sentiment among manufacturers in the state of New York. Forecasts/estimates are based on current market conditions, subject to change, and may not necessarily come to pass.

8 Source: Datastream, IBES, MSIM. Data as of 5 August 2019
Investment implications and current portfolio positioning

At the end of July, we increased our equity allocation across our funds, due to our expectations of policy support that would have ultimately kick-started the capex cycle. However, from the beginning of August, we have subsequently de-risked substantially, as we were surprised by sudden developments in both monetary and trade policy. Our portfolio’s exposure to risk assets gradually decreased during the course of the month, from around 47% in equities in the GBaR Fund (volatility target range 4%-10%) at the end of July, to around 25% in equities at the end of August. In addition, in funds that permit their use, we have been using options as a complement to our dynamic asset allocation approach, in order to both reduce our turnover in trading activities and further protect funds from potential downside losses, whilst still allowing for the possibility to participate in upside gains.

With regard to our tactical allocation, in equities, we moved our Asia ex Japan equities exposure from neutral to underweight, as the region continues to be impacted by the trade dispute, on top of existing geopolitical risks. We also initiated a negative signal on German equities, as the growth outlook continues to deteriorate in Germany and the prospects for a turn in relative earnings trends appears limited. In fixed income, we moved our allocation to emerging market local debt from overweight to neutral, as the dollar appeared to be strengthening against emerging market currencies in a risk-off environment. Finally, we also diversified our safe haven assets across all our portfolios, increasing gold and adding Japanese yen to our cash positioning, where permitted. We believed this asset class was still undervalued, if compared with other defensive assets such as Treasuries.

The current situation remains fluid, but at the time of writing we do not believe that the US and China will resolve the remaining issues surrounding the trade war in the near term. Our assumption is that in the near term there will be no resolution between the two countries given the fundamental differences. However, the recent escalation of tensions is a strong endorsement of the positioning we have taken and we will continue to monitor the situation.

Our relatively defensive positioning should protect us from a potential increase in volatility. In the meantime, we should still receive decent upside if there is some sort of resolution. We have provided the target asset allocations of each of our four Luxembourg SICAV funds in the following table, as of 30 August 2019. Please note that the positions we hold in cash are comprised of a combination of cash and short-term money market instruments, along with the backing of the short futures positions we implemented in our portfolios.

<table>
<thead>
<tr>
<th>VOLATILITY P.A.</th>
<th>EQUITY</th>
<th>FIXED INCOME</th>
<th>COMMODITIES</th>
<th>CASH</th>
</tr>
</thead>
<tbody>
<tr>
<td>MS INVF Global Balanced Risk Control Fund</td>
<td>4% – 10%</td>
<td>25</td>
<td>51</td>
<td>5</td>
</tr>
<tr>
<td>MS INVF Global Balanced Income Fund</td>
<td>4% – 10%</td>
<td>25</td>
<td>49</td>
<td>5</td>
</tr>
<tr>
<td>MS INVF Global Balanced Fund</td>
<td>4% – 10%</td>
<td>27</td>
<td>50</td>
<td>5</td>
</tr>
<tr>
<td>MS INVF Global Balanced Defensive Fund</td>
<td>2% – 6%</td>
<td>5</td>
<td>72</td>
<td>5</td>
</tr>
</tbody>
</table>

Source: Global Balanced Risk Control team, Morgan Stanley Investment Management.
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